

Statement of Bill Cibes, March 22, 2010.

The Committee should give a joint favorable report to Raised Bill 5534, AA Establishing a Revenue Accountability Commission, with some amendments.

The charge to the Commission, set out in Section 1(a) of the bill, provides sufficient scope to the Commission to assess the state's revenue structure, and sets out the criteria for assessment.

In order to fulfill its mandate, the Commission needs accurate return-level data. I believe Section 2 provides full access to this data – without the restrictions set out in Section 12-7b of the statutes – but the Committee should carefully review this language to make certain that the Commission's staff can get information about returns. However, it is also essential that the staff be required to maintain confidentiality of this information.

One glaring omission in Bill 5534 is that there is no provision for hiring and paying nationally recognized experts to provide the detailed analysis necessary to fulfill the mandate of the Commission. For reasons set forth below, I believe such support is essential.

Assuming that expenditure reductions, tax expenditure reductions, and revenue maximization can achieve a \$1 billion reduction in the projected annual deficit of \$3.8 billion in FY 2012 and in each subsequent fiscal year, that still leaves a hole to fill. Unless you're a math atheist, subtracting \$1 billion from \$3.8 billion equals \$2.8 billion – an amount that must be raised through revenue increases.

So the question is NOT IF taxes will have to be raised, but WHAT taxes it makes sense to raise.

Any proposed tax increases should be closely reviewed to make sure that they meet certain standards:

- not be anti-competitive – so as not to drive business out of the state
- not harm innovation (see the bipartisan Program Review Study on economic development policy)
- ensure the equitable sharing of the total tax burden across all income levels¹
- not be out of line with tax rates in other states – so as not to encourage residents to move to those other states²

¹ The Institute on Taxation and Economic Policy has found that Connecticut taxpayers with family income below the 95th percentile pay a far higher percentage of their income in state and local taxes than the top 5% of taxpayers, and especially the top 1%. ITEP, "Who Pays: A Distributional Analysis of the Tax Systems in all 50 States," (Third Edition) November 2009. See attached summary sheet.

To review the major state and local taxes – sales tax, corporate tax, income tax, and property tax – in a thorough and non-partisan manner, to determine the incidence as well as the revenue potential of these taxes, the state should create a revenue accountability commission, composed of respected state leaders from all walks of life, and supported by respected national consultants (like the consulting arms of the major accounting firms).³ A similar group studied three major taxes in 1990, and produced credible reports which formed a factual foundation for legislative action in 1991 to address similar deficit problems.

Respected, credible, knowledgeable national experts should be able to either validate or explode some major myths about taxes in Connecticut.

For example, there is a myth that taxes on business are extremely high in Connecticut.

But the accounting firm of Ernst and Young, in a study completed in January 2009⁴ for COST (the Council on State Taxation), which was originally created as an advisory committee to the Council of State Chambers of Commerce, found that:

- Businesses in Connecticut are NOT extremely highly taxed in the state, as compared to businesses in OTHER states:
 - The total S & L tax burden on business in Connecticut, as a share of Gross State Product, was tied for SECOND LOWEST in the entire US of A. (see page 15 of the Ernst and Young study)
 - The total S & L tax burden on business in Connecticut, as a share of total taxes levied by S & L government in the state, was SECOND LOWEST in the country. (page 15)
 - The total business share of all STATE taxes in Connecticut was THIRD LOWEST in the country. (page 15)
- Moreover, taxes on businesses in Connecticut are actually growing more slowly than in other states:

² The marginal rate of the personal income tax, for example, should be lower than the top marginal rate of the personal income tax in states like New York (8.97%, and 12.6% in NYC), New Jersey (10.75%), Rhode Island (9.9%), Vermont (9.4%), Maine (8.5%).

³ Being able to draw upon the knowledge and experience of nationally known experts will require an investment – perhaps \$2 million or more. But if the state could invest \$1.5 million in 2009 to study tolls, an investment to study major revenue generators would be worth the money.

⁴ "Total state and local business taxes: 50 state estimates for fiscal year 2008," January 2009, may be accessed at www.cost.org/WorkArea/DownloadAsset.aspx?id=72320 The pages cited provide data tables which detail comparative levels of taxation.

- The percentage growth of taxes on business in CT from FY 2002 to FY 2008 was 7th lowest in the country. (see data on page 16)
- The business share of the total S & L tax growth in Connecticut from FY 2002 to FY 2008 was the LOWEST percentage in the country. (see page 16)

Spokespersons for businesses may not want to hear this information, but it's important that citizens and legislators know the facts. And the facts are that business is not subject to overwhelming tax burdens in Connecticut, as compared to the rest of the states in the country.

Moreover, as Ernst and Young points out, it's important to recognize that expenditures by state and local government BENEFIT businesses (see page 6). The data show that, in Connecticut, the ratio of business taxes to expenditures that benefit business is below the national average. (Connecticut's ratio is 1.74. The national average ratio is 1.83) (see page 7). (Or to make it more sensible, the ratio of expenditures that benefit business to business taxes is ABOVE the national average.)

Finally, the Ernst and Young study shows that the most burdensome tax on business in Connecticut is the property tax. Property taxes in Connecticut are 41.5% of the total S & L tax on businesses. Sales taxes are 21.4%. The corporate income tax is only 7.3% of the total business tax burden in Connecticut (below the national average of 9.6%). (See page 22 of the Ernst and Young study.) So one would probably conclude that it is important to find a way to reduce the property tax burden on Connecticut businesses.

A second myth is that Connecticut has the third highest tax burden in the country.

This myth has been perpetrated by the Tax Foundation. But close examination of the methodology⁵ which the Tax Foundation uses would lead a dispassionate analyst to conclude that there are major flaws in its reasoning.

The Tax Foundation counts taxes levied by other states on Connecticut residents as part of the Connecticut tax burden. But no matter what Connecticut government does, its actions won't affect any out-of-state taxes those residents pay. So it is quite unfair to imply that Connecticut state and local government are to blame for these out-of-state taxes.

- Income taxes paid to New York and/or New York City, paid by Connecticut residents who work in those locations, are counted as part of the tax burden of Connecticut residents. In 2007, according to DRS data, those income taxes paid to other states totaled about \$1 billion.

⁵ The methodology is at: <http://www.taxfoundation.org/files/wp4.pdf>

- Property taxes on vacation or second homes in other states (for example, Vermont, New Hampshire, Maine, South Carolina, Georgia, and Florida) are counted as part of the Tax Foundation's computations of the tax burden on Connecticut residents.
- Severance taxes on oil, natural gas, and coal production by states like Louisiana, Wyoming, and Alaska – and incorporated into the price of energy paid by Connecticut residents – are counted by the Tax Foundation as part of the tax burden on Connecticut residents.⁶

In short, the actions of Sarah Palin and David Paterson and the First Selectmen in New Hampshire were the culprits in raising the tax burden on Connecticut residents – not Governor Rell and the Connecticut General Assembly. The magnitude of the distortion in the Tax Foundation's data is shown in Table 2 of its methodology working paper: \$2,509 of the per capita Connecticut resident tax burden really consists of "Taxes Paid to Other States". The \$2,509 per capita shift is the largest such burden shift in the 50 states.

Finally, remember that the tax burden measured "per capita" – as the Tax Foundation does – significantly underestimates the "tax capacity" of Connecticut residents, because their personal income is so high. Osborne and Hutchinson, in The Price of Government, use a measure of tax burden that far better reflects the "tax capacity" of Connecticut. They analyze the "total state and local revenue" from a state's "own sources" – that is, excluding revenue from the national government – as a percentage of aggregate personal income in the state, as a surrogate for gross domestic product. On that measure, the data reported in The Price of Government,⁷ demonstrates that Connecticut has the FOURTH LOWEST tax burden in the U.S.

THE NEED FOR A NONPARTISAN COMMISSION

A nonpartisan Revenue Accountability Commission can assess the validity of these myths. Supported by national experts, it can also investigate a variety of other issues concerning taxation that are critical to developing an informed, coherent policy concerning the raising of revenue. An addendum to this presentation lays out some issues which I believe should be analyzed.

⁶ The Tax Foundation's Working Paper on methodology is not paginated, but on about page 5, under the heading "1. Which States' Residents Pay the Most in State and Local Taxes" the fifth paragraph discusses shifting the property tax burden from vacation homes in Maine and Vermont to those who own the homes and live in Connecticut and Massachusetts. The sixth paragraph discusses the shift of severance tax burden from Alaska, Wyoming and Louisiana to "energy consumers throughout the United States." And the seventh and last paragraph under this heading specifically discusses counting the income taxes paid to New York as part of the tax burden of Connecticut residents who work in New York.

⁷ The data are reported on page 56. The reasons Osborne and Hutchinson give for using this measure are laid out on page 43.

Let me recount some history here: In 1989-1990, a comprehensive tax analysis was conducted prior to the opening of the 1991 General Assembly session. It was completed under the supervision of the Finance Committee. In today's climate, it would probably work better to have a less partisan oversight structure, perhaps along the lines of maybe 15 people, including several business leaders, several labor leaders, and some legislators, perhaps co-chaired by a gubernatorial appointee, and a legislative appointee.

The CRITICAL thing about the earlier study was that it was funded at a level sufficient to hire the best tax analysts in America to do the work: proposals were solicited from the Big 6 accounting firms (or rather, their consulting arms). The reports should be in the legislative library archives. It is less important WHICH firm was hired than that they provided the best possible analysis in America. It is folly to think that a few in-state economists can do the work that is required here. A TEAM of analysts who are experts in their fields is necessary -- and that's what you get with national consultants.

One firm did a complete analysis of the corporate tax, including various possible changes. One firm did a comprehensive analysis of sales tax alternatives. And one firm did an exhaustive analysis of income tax possibilities, including the construction of a computer model which estimated the revenue impact of different structures, as well as the tax incidence on different taxpayer classes. In 2010, there is also a need to study the property tax and how it could be made fairer and less burdensome to both businesses and individual families.

Obviously, this kind of exhaustive research is going to cost money. But unless this kind of INVESTMENT in expertise is made, the conclusions will not garner respect from all segments of the community. National consultants should be hired, via a competitive process, and then managed well. A reasoned, credible report from the Revenue Accountability Commission – supported by the expertise of the best analysts in the country – is needed before January 1, 2011.

ADDENDUM

So what questions are among those which national experts should exhaustively analyze in 2010?

1. Re sales tax.

A. What possibilities exist for taxing catalog and Internet sales from out-of-state merchants? [Some estimates are that CT loses \$400+ million each year] Is it not possible to get Congress to overturn the North Dakota v. Quill decision? Can interstate compacts get around the Quill issue? Is it possible to beef up collections of the use tax short of getting out of state merchants to remit collections? Hasn't technology developed to the point that merchants anywhere can easily structure algorithms to determine what sales taxes in the various states should be collected and remitted? How long can we continue to permit discrimination against Main Street merchants facing a 6% competitive disadvantage to Internet and catalog out of state merchants?

B. What additional services can be taxed? What do other states tax? Significant services were subjected to taxation in 1989, 1990, and 1991, but there are probably others that can be reached. But to do so probably requires a restructuring of the tax statutes. Right now, all sales of GOODS are subject to the sales tax, unless specifically exempted. But NO SERVICES are subject to the sales tax, unless specifically listed. So non-taxation of services is not listed as "tax expenditures," since it's hard to identify what has been missed. What would be the projected revenue increase associated with taxing specific additional service?

C. Would there be any adverse impact on the economy by taxing additional goods and services? Would Connecticut businesses be put at a competitive disadvantage? [E.g., taxing sales to out-of-state companies would just lead those companies to purchase goods and services from another state's businesses, where they wouldn't have to pay 6% sales tax. Taxing goods that will be resold would pyramid taxes, pricing goods out of range. Etc.]

D. What would be the tax incidence (in terms of affecting the ultimate consumer/taxpayer) on folks of different income classes? If an extension of the sales tax, or an increase in rate, were to occur, wouldn't it hit (the conventional wisdom goes) hardest on low-income people? Even if so, could there be a way to offset such a hit, perhaps through an Earned Income Tax Credit? How much would low-income people have to pay extra if the sales tax went to 7%? Is that a significant burden on families at poverty-level or below? What's the magnitude? If a family would have to pay \$200 more per year, wouldn't that be better than having to pay for

eyeglasses if the family were on Medicaid? Or copays for medical services? How would the tax incidence compare to an increase in income tax rates? (for different income classes?)

2. Re corporate taxes:

A. Why not adopt combined reporting? More and more states are adopting this ostensibly fairer approach. New York just did. The argument against combined reporting is that it would drive major headquarters companies (like GE and UTC) out of the state. Would it?

B. What is the benefit of each tax credit? Are they still justified? Can or should they be capped? At what level? What is the practice in other states? etc.

C. Why are some corporations paying no state corporate tax at all to Connecticut? How can we tell? Maybe it's time to drop the "confidentiality" veil, so citizens can see what corporations are getting away scot-free.

D. Why should major business entities escape corporate tax rates by being formed as LLC's or LLPs? Why not impose corporate taxes on these entities once they reach a certain size? Would such an action drive them out of the state? Why should business entities escape meaningful taxation -- only paying the \$250 (or whatever it now is) business entity tax -- while still getting the major benefit of receiving "limited liability"?

E. Are there other corporate tax "loopholes" that enable corporations to escape taxation on a major portion of their profits? Could and should they be closed?

F. Should the weight of the various apportionment factors be changed? Should an apportionment factor be dropped?

G. Do corporate income taxes matter at all to corporations? If Ernst & Young is right, corporate income taxes are a comparatively low burden on Connecticut corporations -- as compared to say, property taxes. Is E & Y right?

3. Re income taxes:

A. What is the effective tax rate (after federal deduction) for various income cohorts? What is the effect of the existing property tax credit on the effective tax rate of those different cohorts? What is the effect of various "adjustments" to income on the effective tax rate of those different

cohorts?

B. How much additional revenue would be raised by increasing the rate on families earning more than \$200,000 or \$300,000 per year? By scaling such rate increase as income increased? By applying increased rates marginally, or alternatively, with a reachback to all income less than each threshold?

C. How much additional tax would be paid by families and singles and heads of households at specified income levels, such as \$200K, \$300K, \$400K, \$500K, \$600K, \$700K, etc, at \$100 K intervals for various marginal rates or reachback rates? Here is where a computer model would be critical, so that different scenarios could be explored.

D. What would be the competitive impact compared with other states? [The marginal (and maybe, depending on whom you talk to, a reachback rate) in NYC is now above 12.6% for families earning more than \$1 million. It's hard to see why a Connecticut family would move to NYC from Connecticut.]

4. Re property taxes:

A. What is the unfairness quotient of disparate property tax rates in CT? What actions can be taken to diminish the inequity?

B. Are property taxes a far higher burden on business than sales or corporate income or personal income taxes? Would it make sense to alter the mix? How does the weight of the property tax in the Connecticut tax mix compare with other states?

C. Can the existing property tax credit against the income tax be made more equitable? Why should renters without cars receive no benefit, while property owners receive \$500 in benefit (at the lowest income levels)? Why should property owners in New Canaan receive the same benefit as property owners in New Britain? Is there a way to make things more equitable?

D. Why should an owner of an automobile in New Britain pay far more in property taxes on the car than the owner of the same automobile in Farmington? Is there a way to make things more equitable?

E. Why should property owners in one town where 50% of the land is tax-exempt pay far higher property taxes than owners in other towns where 5% of the land is tax-exempt? Is there a way to make things more equitable?

5. Re overall:

A. What is the overall tax incidence (including all state and local taxes) on various income cohorts? Is it possible to adjust the various taxes so that revenue can be increased and still tax all income categories fairly? (So that, e.g., families earning \$3 million per year pay only, after federal offset, 4.9% of their income in S& L taxes, while a family earning \$20,000 pays more than 12% in S&L taxes? Is there any rationale at all for this?)

To answer questions like these, with some possibility that the answers would be respected, it is essential that some national consultants be retained to provide answers that will be seen as unbiased, impartial, and nonpartisan.

National consultants should be hired, via a competitive process, and then managed well.